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SUBJECT: FINANCE MINISTER SOLBES CLEANS UP BOOKS

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1. SUMMARY: Finance Minister Pedro Solbes announced July 16 his intention to add EUR 6.14 billion (USD 7.4 billion), or 0.78% of GDP, of non-performing government investments to the 2004 budget. This is predicted to give Spain its first budget deficit (at 1.2% of GDP), since 1999. These liabilities result from several failed government investments such as the liquidation of the Andalusian Government debt, investments in Radio-Television Espanola, and loans to Argentina. Solbes' report also called for transparency reforms that will increase the amount and clarity of budget information to the public. The opposing Popular Party (PP) has criticized Solbes' move as an attempt to tarnish the former PP administration's image. END SUMMARY.

2. Pedro Solbes, Second Vice-president and Minister of Economy, has revised Spain's 2004 budget accounting by adding EUR 6.14 billion (USD 7.4 billion) in non-performing debts to government liabilities. In his July 16 report to the Council of Ministers, Mr. Solbes revealed that this change will increase Spain's projected 2004 deficit from 0.4% to 1.2% of GDP, and for the first time in three years Spain will report a budget deficit. (The Social Security payments account will add 0.5% of GDP surplus, which originally would have left the government with a budget surplus of 0.1%). Despite this new revised 2004 budget, Solbes projected a GOS budget surplus of 0.1% of GDP in 2005, if the autonomous regional governments maintain balanced budgets.

3. For further background on Solbes' position, we spoke with Jose Luis Kaiser Moreiras, former PP finance advisor and currently in the Ministry of Economy, and Alvaro Sanmartin Antelo, a current Solbes advisor. They explained that EU rules allow certain government investments, known as contingent liabilities, to be kept off the books as long as there is credible evidence of return on those investments. Solbes has decided that some of these investments now show no future feasibility, and has to report them as government expenditures in 2004. Examples of these ventures include the liquidation of debt with the Andalusian government, failed investments in Radio-Television Espanola, and loans to Argentina during its 2001 financial crisis.

4. Solbes also accounted for budget losses of ailing government-owned companies in 2004. If the results of state-owned enterprises do not permit future profitability, then Eurostat requires those losses to appear in the government budget, as Solbes has done. Losses by companies like RENFE (state-owned railroad), AENA (state-owned aviation administration), and the state-owned water company appeared in this new deficit figure.

5. Solbes' report called for greater transparency in the GOS budget. He called for an amendment to the already existing Balanced Budget Law, which would require increased transparency and public information. The transparency amendment would require the GOS to make more information public, require the National Statistics Institute and the Bank of Spain to open their books, and standardize the budgetary schedule and information provided to the public.

6. Mariano Rajoy, Secretary General of the opposition PP, dedicated almost an entire press conference on July 21 to criticizing Solbes' move to include these new deficit figures in the 2004 budget. Rajoy claimed that Solbes is trying to blame the PP administration for "hidden deficits," in spite of the fact that Solbes refuses to use the term to describe PP budgeting. Rajoy added that some of these enterprises might still become profitable in the future, or had already appeared in previous years' budgets. Solbes was head of Eurostat, the EU body that validates all EU state budgets and finances, before taking the Spanish Finance Minister position. He approved the 2004 GOS budget while in that post and Rajoy criticized Solbes for not taking action previously if a deficit problem existed.

7. COMMENT: The PSOE government may not be trying to portray the former PP government as having "hidden" budget deficits, despite sensationalist press reports to the contrary. The timing of these adjustments, post-EU parliamentary elections, may indicate that this is not strictly a campaign tactic.

Solbes may be loading up the 2004 budget with deficit liabilities so that the PSOE can claim 2005 and other future budget surpluses on its record. Adjusting the government accounts at this time is also a positive move for Solbes' image. He can portray himself as a fair and respectable Finance Minister who displays prudent budgeting practices.

MANZANARES